Equity Instruments - Research on Measurement

1. Why is EFRAG consulting?

As part of its Action Plan on Sustainable Finance, the European Commission ("EC") announced it would ask EFRAG to explore potential alternative accounting treatments to ("FV") measurement for long- term investment portfolios of equity and equity-type instruments.

In June 2018, EFRAG received a request for advice from the EC in relation to the accounting requirements for investments in equity instruments.

The request for advice is part of the EC's initiatives to orient capital flows towards investment in sustainable activities.

The request for advice asks EFRAG to consider alternative accounting treatments to measurement at fair value through profit or loss (FVPL) for equity instruments.

According to the request for advice, such possible alternative accounting treatments should serve the following objectives:

properly portray the performance and risks of long-term investment business models, in particular for those equity and equity-type investments that are much needed for achieving the UN Sustainable Development Goals and the goals of the Paris Agreement on Climate Change;

preferably enhance investors' insight in the long-term performance of investments, as opposed to recognising point-in-time market-based value changes in reported profit or loss during the duration of the equity investment.

2. The questionnaire

EFRAG has developed this questionnaire in order to gather views from constituents on alternative accounting treatments to IFRS 9 *Financial Instruments* requirements for equity and equity-type instruments held in a long-term investment business model. Such alternative treatments should serve the objectives mentioned above. Respondents are encouraged to read the EFRAG Secretariat background paper available here.

The EFRAG Secretariat background paper provides background information on the request for advice. It explains how the consultation relates to the EC's initiatives on sustainable growth, illustrates the accounting requirements in IFRS 9 and explores some possible alternative measurement approaches.

The possible alternatives in the background paper are to be considered as examples; respondents may suggest other measurement approaches that they consider appropriate.

Additionally, the background paper provides indications of how the concepts of 'long-term investment business model' and "equity-type instrument" may be considered in the context of the questionnaire.

In addition to submitting replies to the questionnaire, constituents can provide their input on the topic and ask questions about the survey by writing to:
Fredre Ferreira (*fredre.ferreira@efrag.org*), or Isabel Batista (*isabel.batista@efrag.org*).

Respondents are encouraged to respond to all questions but are not required to do so. EFRAG will still consider their answers.

EFRAG will disclose the responses, unless a respondent asks for confidentiality.

Please complete this survey by 5 July 2019

3. General information about the respondent

1. Name of the individual/ organisation

German Insurance Association (GDV)

2. Country of operation

Germany

3. Job title

Head of Accounting

4. E-mail address

h.saeglitz@gdv.de

5. Are you currently engaging in a long-term investment business model?

Yes

6. How do you define long-term investment business model?

The insurance business model is via nature a long-term one. In particular, the insurance business is based on the mutualisation of risks and the law of large numbers which ensures an appropriate level of predictability, so that for example insurers are not exposed to the risk of fire sales with regards to investments undertaken. On contrary, insurers have the ability to invest with a long-term perspective and to keep the investments to maturity (e.g. debt instruments) or the date predefined for particular investments (e.g. equity investments). Hence, this long-term perspective of insurance undertakings is an important aspect to be considered when assessing the appropriateness of the general financial reporting requirements for insurers.

7. Are you currently engaging in investment of sustainable activities?

Yes

8. How do you define sustainable activities?

As the discussion on this topic (e.g. EU taxonomy) is currently ongoing at the political level and as we prefer rather an entity-specific approach to define whether and how the sustainability idea is considered for example in investments activities by particular insurers, we recommend abstaining from defining "sustainable activities" for financial reporting purposes here. We also like to observe that sustainability is neither explicitly defined by IASB for the purpose of IFRS nor by the European Commission for the purpose of the EU endorsement of IFRS standards.

4. Question 1

9. IFRS 9 allows an entity to account equity instruments either at FVPL or, if applicable, at fair value through other comprehensive income (FVOCI) without impairment and without reclassification (“recycling”) to P&L upon disposal of valuation gains or losses previously recognized through OCI ("IFRS 9 requirements" for equity instruments).
When defining an accounting treatment alternative to IFRS 9 requirements for equity instruments held in a long-term investment business model, which characteristics would you require to identify a *long-term investment business model*?

Other

If you have indicated "Other" please provide details

We would not prefer and also believe that it is not necessary to define the long-term investment business model for the purpose outlined in the question here. The definition should be rather negative; i.e. refer to instruments not held for short-term trading purposes.

Only as the second best approach we suggest that a reference to the business model of the investor should be considered; similarly to the approach of IFRS 9 Financial Instruments. IFRS 9.4.1.1 states that an entity should classify financial assets on the basis of the entity's business model for managing the financial assets. This consideration of the insurance business model is explained in some more detail in Example 7 in IFRS 9.B4.1.4C. Example 7 creates indeed a link between holding financial assets and funding of insurance contracts liabilities and clarifies that insurer might undertake "significant buying and selling activity on a regular basis to rebalance its portfolios of assets and to meet cash flows needs as they arise". On this basis Example 7 is analysed as providing a situation in which collecting contractual cash flows and selling financial assets are integral to achieving the business model's objective. In such a case IFRS 9.4.1.2A foresees for debt instruments the FVOCI treatment. It's only consequently that also for equites FVOCI treatment is available. We believe that accounting for equity instruments could be based also on this business model consideration, though IFRS 9.4.1.4 is defining it in a different way, hence, the same outcome is achieved.

5. Question 2

10. In your view, is an alternative accounting treatment to IFRS 9 requirements needed to properly portray the performance and risks of equity instruments held in a long-term investment business model?

Yes

6. Question 3

11. Explain the reasons for your reply to question 2, including the key operational challenges in developing a different accounting treatment to IFRS 9 requirements

In our strong view the current IFRS 9 requirements are preventing insurance undertakings from proper reflection of their investment performance when non-trading equity investments are considered. In particular, gains or losses on disposal are prohibited from being recognised in the profit or loss statement; hence a significant part of the equity instruments performance is not properly portrayed when the FVOCI option is used.

Hence, the recycling ban for FVOCI equity investments is creating a disadvantage for such investments when comparing to debt instruments accounted for at FVOCI or to equity instruments accounted for at FVPL. However, the current accounting at FVPL is not appropriate when the OCI option is a preferable one with regard to the current accounting treatment for insurance liabilities under IFRS 17 Insurance Contracts. There is a need to ensure a level playing field for all investments while considering the integral linkage to IFRS 17 at large.

We believe that the systematic deficiency with the standard IFRS 9 associated to the recycling ban on equities held for long-term as identified by EFRAG in its endorsement advice on IFRS 9 should be approached by the IASB ahead of the (tentatively revised) effective date of IFRS 17. Having this view that it is up to the IASB to provide a targeted fix to IFRS 9 to remove the existing disadvantage for FVOCI equities we do not believe it is useful provide any further concrete suggestions how to design a recycling model for FVOCI equities. Any recycling approach (with or without impairment) would be more preferable to the current status quo.

7. Question 4

12. With reference to equity instruments held in a long-term investment business model, if you support measurement at FV through other comprehensive income with reclassification to P&L upon disposal of the valuation gains or losses previously recognized through OIC (so called "recycling"), which impairment model would you suggest and how it would work in practice?

We don't believe that an impairment model is absolutely indispensable to reintroduce recycling for FVOCI equities. Allowing for recycling of gains or losses on underlying equity investments at their disposal only would be the most pragmatic and robust recycling approach. In such a case both gains and losses would be recognised in profit or loss upon disposal and any unrealised market driven fair value changes would be transparently reflected in OCI, in accordance with the current OCI presentation for equites (i.e. without recycling).

However, being aware of the outcome of the previous EFRAG consultation on the Discussion Paper "Equity Instruments – Impairment and Recycling" (March 2018) we like to express that we would not oppose a robust impairment model to be introduced as a precondition to recycling being reintroduced for FVOCI equites in IFRS 9.

And we understand that while the revaluation model (i.e. lower of cost or market approach, LCM approach) would provide a high level of rigour and would reduce any subjectivity/discretion to the most extent possible, the majority of stakeholders responding to the consultation preferred an impairment model similar to the one in IAS 39 with less subjectivity. The latter approach would be capable of making a difference whether a permanent decline in fair value or only a temporary short-term fair value movement ('market noise') is given. In both cases, i.e. irrespective if the LCM approach or IAS 39 oriented model is preferred; the possibility of reversal of previously recognised impairment losses should be given in any case. In addition, we would not oppose including quantitative impairment/reversal triggers if considered necessary to achieve rigorous impairment recognition.

It is our firm position that any of these three alternatives above are superior to the status quo. Hence, keeping the status quo and not approaching the recycling ban on FVOCI equites as a major deficiency of IFRS 9 in this regard would not be an adequate approach.

Finally, recycling ban remains not to be in line with the principle of the revised Conceptual Framework supposed to provide principles underlying the IFRS accounting. Conceptual Framework recommends that recycling of amounts accumulated in other comprehensive income (OCI) occurs, unless there is no robust basis for when it should occur. We believe that the period of disposal (or impairment if required) of financial instruments provides a robust basis for determining at which point in time recycling would be required to occur. Only allowing for recycling would ensure that the profit or loss fulfils its role as a primary source of information about the entity's financial performance for the period.

Summing up, there is a conceptual urgency to abolish the recycling ban on equity instruments accounted for at FVOCI. There is also a need to address this issue ahead of the (tentatively revised) effective date of IFRS 17. And finally, there is enough experience with the perceived deficiencies of IAS 39 model to find a way to overcome them; either via making this IAS 39 impairment model less subjective or via taking another alternative impairment approach as a more suitable basis. Doing nothing is not an option to proceed. In addition, it is not in line with the core presumption of the IASB that presentation and disclosures cannot replace the proper recognition and measurement in the primary financial statements (IAS 1.18).

Finally, for further details on our positions regarding recycling and design of an impairment model for equities we refer to our GDV detailed comments provided on the EFRAG's Discussion Paper "Equity Instruments – Impairment and Recycling" (March 2018) of 17 May 2018.

8. Question 5

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13. Should the different accounting treatment be restricted to equity instruments held in a long-term investment business model?

For more detail, please refer to paragraphs 4.3 to 4.29 of the Background paper.

No

14. Please explain your answer

To avoid any misunderstanding: the different accounting treatment for equities we argue for is the existing FVOCI Option, but with recycling. Thus, we don't believe that there is a need to create a subgroup of equity investments for which the exsiting recycling ban should be abolished only. The same way the IASB decided not to restrict the FVOCI option to 'strategic investments' only. And this is the basis further IASB's work should build on.

Consequently, any potential impairment approach seen as precondition to the reintroduction of recycling should apply to all equity instruments eligible for the irrevocable FVOCI option in IFRS 9.

9. Question 6

15. As per IFRS 9, equity-type of instruments, such as units of investment funds, do not meet the definition of equity instrument of IAS 32 Financial Instruments: Presentation, therefore are not eligible for the option to mesure them at fair value through comprehensive income ("FVOCI"). At the same time, they are not eligible for measurement at amortised cost (as they have contractual cash flows that are not Solely Payments of Principal and Interest, "SPPI" instruments). As such, IFRS 9 requires to account for them at FVPL; no FVOCI option is granted ("IFRS 9 requirements for equity-type instruments").

Should the different accounting treatment referred to in the previous questions be extended to instruments that are "equity-type"?

For more detail please refer to paragraph 4.30 to 4.39 of the Background paper.

Yes

16. Please explain your answer

We believe that long-term investments in equity instruments should be treated consistently under IFRS 9, irrespective if they are held directly or indirectly. Therefore, we would prefer equity-type instruments to be eligible for the scope of FVOCI option / including recycling likewise.

To achieve this it should be ensured that a symmetric treatment between IAS 32 und IFRS 9 is established, i.e. financial instruments eligible for presentation as equity according to IAS 32 should be treated as equity instruments for the purpose of IFRS 9. The current situation is difficult to understand and prevents for example typical private equity structures to be properly portrayed in the investors' financial statements.

10. Question 7

17. If so, which characteristics would you require to define the "equity-type" instruments?

Units of funds and other instruments that meet the 'puttable exception' in IAS 32

18. If you have indicated "Other" please provide details

11. Question 8

19. With reference to equity and equity-type instruments held in a long term investment business model, please rate how relevant a different accounting treatment is to the objective of reducing or preventing detrimental effects on investment in sustainable activities in Europe.

95

12. Question 9

20. Are there other characteristics that would justify an accounting treatment different than IFRS 9 requirements for equity instruments and equity-type instruments held in a long-term investment business model? Please provide examples.

Just to state the obvious and to avoid any misunderstanding: We are not arguing for a different accounting treatment per se; we only urge that the identified existing accounting disadvantages for FVOCI treatment in IFRS 9 should be removed.

13. (untitled)

The following pages include 7 illustrative examples of long term investment. For each scenario, you are invited to answer the questions on the page which follows.

Please consider that for Scenario A, B, C and D IFRS 9 requires to either measure the investment at FVTPL or to elect the option for measurement at FV through other comprehensive income, without reclassification to P&L, upon disposal, of the valuation gains or losses previously recognized through OCI, and without impairment.

14. Illustrative example A - Wind farm with predetermined useful life

21. For scenario A - In your view, is a different accounting treatment needed in order to meet the following two objectives? (i) properly portray the performance and risks of long-term investment business models, in particular for those equity and equity-type investments that are needed for achieving the UN Sustainable Development Goals and the goals of the Paris Agreement on Climate Change; and (ii) preferably enhance investors' insight in the long-term performance of investments, as opposed to recognising point-in-time market-based value changes in reported profit or loss during the duration of the equity investment.

Yes

If yes, please explain why.

22. Which element in the scenario is more relevant for your reply?

1. The investor's inability to dispose of the shares

23. Which accounting treatments do you support?

Other

In case you would support an Accounting treatment other than the examples explored in the EFRAG Secretariat Background paper and/or you have selected “Other”, please illustrate the accounting treatment you would support and why.

We would opt for the FVOCI treatment with impairment and recycling.

15. Illustrative example B - Unlisted single equity instrument

24. For scenario B - In your view, is a different accounting treatment needed in order to meet the following two objectives? (i) properly portray the performance and risks of long-term investment business models, in particular for those equity and equity-type investments that are needed for achieving the UN Sustainable Development Goals and the goals of the Paris Agreement on Climate Change; and (ii) preferably enhance investors’ insight in the long-term performance of investments, as opposed to recognising point-in-time market-based value changes in reported profit or loss during the duration of the equity investment.

Yes

If yes, please explain why.

25. Which element in the scenario is more relevant for your reply?

1. The fact that the shares are unlisted

26. Which accounting treatments do you support?

Other

If you would support an Accounting treatment other than the examples explored in the EFRAG Secretariat Background paper and/or you have indicated "other", please illustrate the accounting treatment you would support and why.

We would opt for the FVOCI treatment with impairment and recycling.

16. Illustrative Example C - Open portfolio of equity instruments held with a view to service a long-term insurance liability

27. For scenario C - In your view, is a different accounting treatment needed in order to meet the following two objectives? (i) properly portray the performance and risks of long-term investment business models, in particular for those equity and equity-type investments that are needed for achieving the UN Sustainable Development Goals and the goals of the Paris Agreement on Climate Change; and (ii) preferably enhance investors' insight in the long-term performance of investments, as opposed to recognising point-in-time market-based value changes in reported profit or loss during the duration of the equity investment.

Yes

If yes, please explain why.

28. Which element in the scenario is more relevant for your reply?

1. The link to a long-term obligation (insurance contracts)

29. Which accounting treatments do you support?

Other

If you would support an Accounting treatment other than the examples explored in the EFRAG Secretariat Background paper and/or you have indicated "other", please illustrate the accounting treatment you would support and why.

We would prefer the FVOCI treatment with recycling (incl. impairment).

The current value, i.e. the fair value measurement for the purpose of the balance sheet is necessary to achieve a treatment aligned with the current fulfilment measurement of insurance liabilities according to IFRS 17 Insurance Contracts, in line with the asset-liability management (ALM) of insurers. However, only realised gains or losses on financial instruments are part of the performance which needs to be presented in profit or loss statement. The unrealised fair value changes which are not caused by impairments (re financial instruments) or changes due to changes in discount rate (re insurance liabilities) are irrelevant for the purpose of performance reporting in periods before disposal respective settlement ('market noise'), therefore the two-sided OCI option is preferable. The missing part for the aligned treatment for insurance liabilities (IFRS 17) and financial instruments (IFRS 9) is the recycling option for the FVOCI equities.

17. Illustrative Example D - Open portfolio of equity instruments held with a view to service a long-term liability

30. For scenario D - In your view, is a different accounting treatment needed in order to meet the following two objectives? (i) properly portray the performance and risks of long-term investment business models, in particular for those equity and equity-type investments that are needed for achieving the UN Sustainable Development Goals and the goals of the Paris Agreement on Climate Change; and (ii) preferably enhance investors' insight in the long-term performance of investments, as opposed to recognising point-in-time market-based value changes in reported profit or loss during the duration of the equity investment.

Yes

If yes, please explain why.

31. Which element in the scenario is more relevant for your reply?

1. The link to a long-term obligation

32. Which accounting treatments do you support?

Other

If you would support an Accounting treatment other than the examples explored in the EFRAG Secretariat Background paper and/or you have indicated "other", please illustrate the accounting treatment you would support and why.

Generally, we would prefer the FVOCI treatment with recycling (incl. impairment).

The ultimate answer is however dependent on the nature of the long-term liability, i.e. its respective accounting treatment (e.g. cost, full fair value). The ALM-strategy is best reflected if the assets and liability accounting is neither causing artificial volatility nor leading to accounting mismatches in both balance sheet and performance reporting.

18. Illustrative example E - Long-term investment held indirectly through a unit fund - listed

33. For scenario E - In your view, is a different accounting treatment needed in order to meet the following two objectives? (i) properly portray the performance and risks of long-term investment business models, in particular for those equity and equity-type investments that are needed for achieving the UN Sustainable Development Goals and the goals of the Paris Agreement on Climate Change; and (ii) preferably enhance investors' insight in the long-term performance of investments, as opposed to recognising point-in-time market-based value changes in reported profit or loss during the duration of the equity investment.

Yes

If yes, please explain why.

34. Which element in the scenario is more relevant for your reply?

1. The investor's assessment of the long-term nature of its investment

35. Which accounting treatments do you support?

Other

If you would support an Accounting treatment other than the examples explored in the EFRAG Secretariat Background paper and/or you have indicated "other", please illustrate the accounting treatment you would support and why.

We would prefer the FVOCI treatment with recycling (incl. impairment).

19. Illustrative example F - Long-term investment held indirectly through a unit fund – non listed

36. For scenario F - In your view, is a different accounting treatment needed in order to meet the following two objectives? (i) properly portray the performance and risks of long-term investment business models, in particular for those equity and equity-type investments that are needed for achieving the UN Sustainable Development Goals and the goals of the Paris Agreement on Climate Change; and (ii) preferably enhance investors' insight in the long-term performance of investments, as opposed to recognising point-in-time market-based value changes in reported profit or loss during the duration of the equity investment.

Yes

If yes, please explain why.

37. Which element in the scenario is more relevant for your reply?

1. The investor's assessment of the long-term nature of its investment

38. Which accounting treatments do you support?

Other

If you would support an Accounting treatment other than the examples explored in the EFRAG Secretariat Background paper and/or you have indicated "other", please illustrate the accounting treatment you would support and why.

We would prefer the FVOCI treatment with recycling (incl. impairment).

20. Thank You!

Thank you for taking our survey. Your response is very important to us.